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TAGS: ECON EFIN PGOV VE
SUBJECT: BRV DEVELOPS PUBLIC FINANCE TOOLS TO SQUEEZE
STATES AND MUNICIPALITIES

REF: A. CARACAS 559
¶B. CARACAS 1090
¶C. 2007 CARACAS 2040
¶D. CARACAS 1435

Classified By: Economic Counselor Darnall Steuart for reasons 1.4 (b) and (d).

¶1. (C) Summary: The Bolivarian Republic of Venezuela's (BRV's) public finance system has undergone a series of important changes since 2005 that give the Executive the tools to limit significantly the resources available to state and municipal governments. These governments receive the vast majority of their funding from constitutionally or legally mandated transfers from the central government, largely calculated as a percentage of estimated ordinary central government revenue. By diverting what would have been ordinary revenue to fund quasifiscal (i.e., off-budget) spending, the BRV has already cut into the automatic take of state and municipal governments. The BRV has or is developing additional tools that can accomplish the same purpose, including sending some of the transfers to community councils rather than state and municipal governments and opening the door to the appointment of new regional authorities, which would presumably also take a portion of the transfers. Our contacts believe the BRV will make extensive use of these tools to restrict the resources available to states and municipalities won by the opposition in upcoming elections scheduled for November 23, 2008, as President Chavez has indeed threatened. End summary.

A Dependent Decentralization

¶2. (U) Venezuela's constitution and several key laws entitle state and municipal governments to transfers from the central government. The most significant of these transfers is known as the "situado constitucional." Per Article 167 of the constitution, states are entitled to receive between 15 and 20 percent of ordinary central government revenue as estimated annually by the Executive. This amount is divided among Venezuela's 23 states by a formula under which 30 percent is split equally by the states and the remaining 70 percent is divided in proportion to population. Per the constitution, twenty percent of the amount going to a given state must be disbursed to municipalities in that state. This amount is determined by a formula taking each

municipality's population and area into account. The 2008 budget designated 18 percent of estimated ordinary revenue, or 22.3 billion bolivars (Bs; USD 10.4 billion at the official exchange rate), for the situado. The actual amounts transferred in the previous three years ranged from 16.5 to 20 percent of actual ordinary revenue.

¶3. (U) States and municipalities also receive funds from the central government based on the Law of Special Economic Assignments (LAEE), Law of the Intergovernmental Fund for Decentralization (Fides), and special contributions (states only). LAEE obligates the central government to transfer 25 percent of actual ordinary revenues (including taxes and royalties) from oil and mining activities after subtracting from the revenues the portion that goes to the situado. Fides obligates the central government to transfer at least 15 percent of estimated income from the value-added tax (IVA). As of 2007, LAEE and Fides transfers, which used to be split between states and municipalities, are split between states (42 percent), municipalities (28 percent), and community councils (30 percent). LAEE and Fides transfers are small relative to the situado. In the 2008 budget, they are estimated at Bs 4 billion (USD 1.9 billion) and Bs 1.6 billion (USD 750 million) respectively. The states also receive special contributions to fund health and other programs, budgeted at Bs 3.7 billion for 2008.

¶4. (SBU) Municipalities and particularly states are dependent on these transfers, especially the situado, for the vast majority of their revenues. Municipalities are able to levy a variety of taxes on businesses per the Municipal Powers Law. Our contacts estimate that a typical municipality generates roughly 20 percent of its total revenue through these taxes, with the remaining 80 percent coming from the central government transfers. (Note: The Ministry of Finance estimates the average ratio across all municipalities as closer to 40/60, perhaps reflecting the exceptional situation of a few wealthy municipalities like Chacao, which generates 85 percent of its total revenue. End note.) States, which can only levy certain relatively minor taxes and fees, are even more dependent on central government transfers. Our contacts estimate that roughly 95 percent of states' budgets come from these transfers, a figure confirmed by the budget office of Aragua state and consistent with Ministry of Finance estimates.

Changing the Paradigm

¶5. (SBU) Prior to 2005, the vast majority of BRV revenue and spending was channeled through the normal budget process, with a percentage of revenue transferred to states and municipalities as described above. This paradigm changed significantly with the creation of the National Development Fund, known as Fonden, in 2005 and the associated increase in "social spending" by PDVSA. Fonden is the most important of a growing array of quasifiscal funds managed by the Executive outside the budget process and with minimal oversight. From the perspective of state and municipal governments, the significance of Fonden and increased social spending by PDVSA is the diversion of what otherwise would have been ordinary central government revenue subject to mandated transfers. According to its financial statements, PDVSA transferred to Fonden or spent on social programs a total of USD 27 billion in 2006 and 2007. PDVSA deducted this amount from its profits before calculating the income tax owed to the central government, thus reducing ordinary central government revenue by approximately USD 13 billion and situado transfers by USD 2.6 billion, or 10 percent of what it otherwise was. The windfall profits tax, imposed in April 2008, is also paid directly to Fonden and bypasses the central government (ref A).

¶6. (SBU) The BRV has or is developing other tools that could be used to reduce mandated transfers to state and municipal governments. As noted above, the BRV has begun to earmark 30

percent of Fides and LAEE transfers to community councils. As the authority to license community councils rests with the Office of the Presidency, these entities are more likely to follow BRV guidance than elected state and municipal governments. State and municipal governments may also get squeezed from above. The Organic Law of Public Administration passed under the Enabling Law (ref B) gives the Executive the right to appoint "regional authorities" and assign them the necessary resources. If such authorities are created, many observers expect that the BRV will fund them with a cut of the situado transfer that would otherwise have gone to state and municipal governments, even if doing so seemingly violates the constitution.

¶7. (SBU) The BRV can also reduce mandated transfers by reducing estimated ordinary revenues in other ways. For revenue to be considered ordinary, it must be collected for three continuous years. Thus, by reducing a longstanding tax and imposing a new or temporary one, the BRV can reduce mandated transfers while maintaining the same revenue levels. Indeed, the BRV did exactly that in 2007 by lowering the IVA and imposing a temporary tax on financial transactions (ITF), the proceeds of which counted as extraordinary revenue. This change was significant for state and municipal governments, as ITF proceeds from January to June 2008 (when the tax was abolished) were 10 percent of ordinary revenue. Another tool in the BRV's arsenal is its practice of lowballing estimated ordinary revenues (ref C). The difference between actual and estimated non-oil revenues, which used to be automatically subject to the situado, is now transferred to another discretionary quasifiscal fund, Fondo Miranda. Central government oil revenues can easily be manipulated using social spending and transfers to Fonden. Thus, whether state

and municipal governments receive additional situado transfers to compensate for the difference between estimated and actual ordinary revenue is completely at the discretion of the Executive.

Comment

¶8. (C) Decentralization has only gone so far in Venezuela. State and municipal governments are directly elected but heavily dependent on transfers from the central government for their funding. While the "situado" may be mandated by the constitution, it and other transfers are not above the political fray. President Chavez has developed the tools to put the squeeze on state and municipal governments if he so chooses, and indeed he has explicitly threatened to do so where opposition candidates prevail in upcoming elections (ref D). We believe Chavez will carry out this threat to whatever degree he calculates will be to his political advantage, cognizant that opposition executives will seek to pin the blame on him for any budget cutbacks. Inflation and the international financial crisis may work to Chavez' advantage in this regard. Given 30 percent inflation, a nominal increase in transfers of, say, 10 percent could actually seriously impair the capacity of state and municipal leaders to undertake new initiatives. Indeed, we take warnings from President Chavez and Finance Minister Rodriguez of an "austerity" budget for 2009 less as an indication that the BRV will reduce its spending (as the BRV can supplement a tight budget with quasifiscal spending) and more as a way of setting expectations for reduced transfers to state and municipal governments. The international financial crisis provides Chavez with a handy scapegoat for this "austerity." End comment.
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